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July 10, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Capital Account Convertibility - Review of Experience and Implications for Fund Policies

Attached for consideration by the Executive Directors is a paper on review of experience and implications for Fund policies relating to capital account convertibility, which is tentatively scheduled for discussion on Friday, July 28, 1995. Issues for discussion appear on pages 18 and 19.

Mr. Quirk (ext. 38520) or Mr. O. Evans (ext. 37183) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Capital Account Convertibility: Review of Experience and Implications for Fund Policies

Prepared by the Monetary and Exchange Affairs and Policy Development and Review Departments

(In consultation with other Departments)

Approved by Manuel Guitián and Jack Boorman

July 7, 1995

Contents

I. Introduction

Issues relating to the movement of capital among countries have become central to the Fund's role in the international monetary system as embodied in the Articles of Agreement. During the last biennial review of surveillance concluded in April 1995, Directors agreed that financial market and capital account issues deserved more attention by the Fund, and amended the 1977 surveillance decision to take into account more explicitly the role of capital flows. The Madrid Declaration of the Interim Committee in October 1994 welcomed the growing trend toward currency convertibility and encouraged member countries to remove impediments to the flow of capital. In an Executive Board seminar on the international exchange and payments system in November 1994, several Directors called for a review of the Fund's potential role in monitoring capital account restrictions and encouraging capital account liberalization. 1/ This paper reviews the main issues relating to capital account convertibility by Fund members and the implications for Fund policies and jurisdiction. 2/

The paper is organized as follows: Section II summarizes the main issues arising from experiences of industrial and developing countries with capital account liberalization and examines the Fund's treatment of capital controls in its surveillance, use of Fund resources, and technical assistance activities. Issues in extending the Fund's role in promoting capital account liberalization are examined in Section III, which is followed by a summary of issues for discussion by the Board in Section IV. 3/

1/ "Issues and Developments in the International Exchange and Payments System" (SM/94/202, 8/1/94 and SM/94/202, Sup. 1, 8/12/94; BUFF/94/106, 11/23/94; Executive Board Seminar 94/10, 11/16/94).

2/ For the purposes of this paper, capital account convertibility refers to freedom from exchange controls--quantitative controls, taxes, and subsidies--applicable to transactions in the capital and financial accounts of the balance of payments. Discussions of currency convertibility have focused on these forms of capital controls, although restrictions are often imposed on real (underlying) transactions as, for example, on inward foreign direct investment. Restrictions on underlying aspects of the transactions are excluded from the definition of capital account convertibility for purposes of this paper. The concept of capital controls employed in this paper also does not include limits on foreign exchange exposure placed for prudential purposes, nor domestic monetary or fiscal measures that do not have a direct and differential impact on foreign exchange transactions.

3/ A background paper provides further details on the issues raised in Section II of this paper. Its Annex describes the institutional frameworks for capital account liberalization in the OECD and EU, surveys capital controls in effect in developing countries, and presents selected country cases. An accompanying paper also surveys the literature on capital controls.

II. Issues in Capital Account Convertibility

At a conceptual level, it is generally acknowledged that a free and open system for capital movements would contribute to the efficient allocation of world saving and enhance welfare of participating countries. However, a strand of theoretical models also suggests that as a "second-best" solution, restrictions on capital movements may be welfare improving in the presence of pre-existing distortions. Accordingly, the preconditions for realizing the benefits of liberalization may not be present and some countries continue to restrict capital movements. Empirical literature on the other hand, while not conclusive, generally points to the ineffectiveness of controls in sustaining inconsistent macroeconomic policies. 1/

Over the last two decades, many countries have liberalized their capital accounts. Industrial countries adopted capital convertibility almost universally in the 1970s and 1980s, building on a process of international economic integration that was already well advanced in the area of trade in goods and services. The trend was facilitated by the OECD Code of Liberalization of Capital Movements, which was introduced in a limited way in 1961 and later extended in stages to encompass the full range of capital account transactions by 1989. The adoption in 1988 by the EU of the second directive on liberalization of capital movements was also instrumental. 2/ Many developing countries have lifted controls on capital movements, most relatively recently. A majority among them still retains such controls de jure 3/ but de facto the controls are less prevalent. The group with remaining controls may be expected over time to seek the benefits of full

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1/ For a survey of literature on capital controls see the accompanying paper "A Survey of Academic Literature on Controls Over International Capital Transactions" (SM/95/164, 7/7/95, Sup. 3).

2/ The codes and directives have since undergone revisions: OECD, Code of Liberalization of Capital Movements (Paris, 1992), and EU, "The Agreement on the European Community Area," Chapter 4, (Luxembourg, 1992).

3/ Developing countries with an open capital account include a number of oil-exporting developing countries with relatively strong balance of payments positions, most Latin American and Caribbean economies, Hong Kong, Lebanon, Malaysia, Singapore, Thailand, a few countries in Africa (The Gambia, Kenya, and Mauritius), the Baltic countries (Estonia, Latvia, and Lithuania) and the Kyrgyz Republic.

integration into global markets through more open capital accounts, although the transition to a liberalized capital account raises important issues, as discussed below. 1/

1. Transition to an open capital account

Moving to capital account convertibility requires careful consideration of the following: (i) whether there is a set of preconditions that should be established before the capital account is liberalized and how liberalization measures should be sequenced; (ii) whether, in view of the integration and development of international financial markets, restrictions on capital flows can be effectively enforced; and (iii) whether difficulties might arise in the conduct of macroeconomic policies following liberalization, and what they might be. In addition, separate issues arise when considering whether under particular circumstances the temporary reimposition of controls, especially on capital inflows, can be appropriate.

a. Preconditions and sequencing

As described in the background paper, recent experience tends to support the view that freeing capital account transactions should be undertaken subsequent to, or at least broadly simultaneously with, certain other reforms. The most important among these are domestic financial market reforms, and a strengthened capacity to adapt fiscal policy so as to keep resource pressures from arising when private demands mount. The centerpiece of financial sector reform would be to ensure that interest rates are internationally competitive, thus reducing pressures on the balance of payments and the exchange rate. 2/ Strengthening prudential regulations and requirements are also key to successful capital account liberalization; where there is generous government deposit insurance, or where there is a presumption that large banks will not be permitted to fail, there may be

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1/ Specific multilateral or regional provisions for capital account liberalization have been much less prominent in developing countries. In the East Caribbean, a regional agreement to permit free intraregional flows meant effective multilateral capital convertibility because of an open system maintained by one member (Anguilla). The relationship of the franc zone countries to France has resulted in a similar situation, although the effect of new uniform foreign exchange regulations for BCEAO and BEAC member countries has yet to be clarified. The use of another country's currency has implied capital account convertibility in other instances (Kiribati, Liberia, the Marshall Islands, Panama, and San Marino).

2/ Liberalizing countries have for the most part raised negative real interest rates to such levels prior to or simultaneously with opening the capital account, and in the few other cases the adjustment occurred soon after. Virtually all had systems of monetary policy management that did not depend on credit rationing.

incentives for banks to take on excessive risk, and capital account liberalization could open up further high-risk opportunities for depository institutions. 1/

The type of exchange rate regime appears not to be a critical factor in successfully moving to capital account convertibility. Notwithstanding a trend toward more flexible exchange arrangements in developing countries, 2/ experience to date shows that countries have liberalized their capital accounts in the context of both flexible and fixed rate regimes, including currency board-type arrangements. What would appear paramount is, if necessary, an initial adjustment of the exchange rate to a realistic level, followed by pursuit of an appropriate policy mix that avoids abrupt adjustment in either interest rates or exchange rates. In particular, as noted above, fiscal policy should be sufficiently adaptable to sustain macroeconomic stability. Most, but not all, countries liberalizing the capital account did so in the context of a comprehensive stabilization package.

On issues of speed and sequencing of capital account liberalization in relation to other reforms, clear-cut lessons are difficult to draw. Liberalization in industrial countries tended to follow the gradual and phased approach to economic reform suggested by the literature, with capital account liberalization typically following relatively broad-based trade and domestic financial reforms. Moreover, experience in the late 1970s and early 1980s, especially in the Southern Cone countries, underlined the dangers of moving too rapidly in opening the capital account without broad-based policy support. More recently, a number of countries have successfully implemented complete packages of reforms over a relatively short period. It could be argued that an advantage of early removal of capital controls would be to limit the ability of vested interests adversely affected by the reforms to marshall political resistance to those reforms. Such an approach may also promote efficiency in the domestic financial sector by injecting competition for funds, improve global intermediation of resources from savers to investors, and allow enterprises and individuals to diversify activities and portfolios abroad. On the other hand, rapid liberalization may leave little time for the adoption of complementary policies, including development of well-functioning financial instruments and prudential arrangements. Several of the countries that have liberalized rapidly experienced problems in the financial sector; in most cases these

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1/ However, a number of the liberalizing countries had at the time of opening the capital account considerable weaknesses in the banking system reflected in large-scale nonperforming assets and an absence of effective prudential risk management systems.

2/ For a recent discussion of developments in this area, see "Issues and Developments in the International Exchange and Payments System," *IMF World Economic and Financial Surveys* (April 1995), pp. 17-20.

difficulties reflected underlying weaknesses that were unrelated to the liberalization, but in some cases the reforms may have exacerbated the existing problems. 1/

In the context of a strong overall balance of payments position, the authorities may wish to minimize exchange rate or monetary pressures that could arise from foreign capital inflows by liberalizing capital outflows before inflows. There could also be a desire to limit short-term inflows that may be regarded as potentially more destabilizing, but to liberalize long-term inflows such as inward direct investment that may be viewed as being more stable and productive. 2/ It may, however, be difficult to achieve such fine-tuning, at least more than temporarily; liberalization of one component of the capital account may create pressures for deregulation of all capital transactions; moreover, there is some evidence that long-term capital flows are not necessarily more stable than flows through instruments with nominally short maturities. 3/

b. Effectiveness of control mechanisms

An important issue in the transition to an open capital account is whether the capital regulations can be enforced to a sufficient extent that they play a significant role. There is by now considerable evidence, particularly with regard to controls on capital outflows, that suggests only limited effectiveness. 4/ Notwithstanding the differentials created by capital controls between domestic and international interest rates, the evidence accumulated now points to the general inefficacy of such controls in maintaining an unsustainable exchange rate. In situations where exchange rate pressures result from capital flight induced by poor policies, there are considerable incentives to circumvent regulations through alternative mechanisms, thereby diminishing the effectiveness of controls.

It has been argued that measures to deter capital inflows have been more effective than those on outflows, both because of the differing circumstances under which the two types of flows emerge as well as the choice of alternatives available in each case. Recent experience suggests that while controls or taxes on inflows should not be viewed as a substitute for fundamental policy measures, especially in the area of fiscal policy, they might serve as temporary supplementary tools which could provide

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1/ See "Capital Account Convertibility: Review of Experience and Implications for Fund Policies--Background Paper", SM/95/164, 7/7/95, Sup. 1, p. 15).

2/ Available evidence suggests, paradoxically, that considerably more Fund members maintain restrictions on inward foreign direct investment than on banking and portfolio flows (see Annex II to the background paper, SM/95/164, 7/7/95, Sup. 2).

3/ Ibid, p. 13.

4/ Ibid., pp. 15-21, and the survey of academic literature, op. cit., pp. 29-37.

policymakers with some additional time to react. However, the experience relates as yet to a relatively small and recent set of countries with surges in inflows. Because quantitative restrictions on inflows are clearly less desirable than those that retain an element of market incentives, in some countries a price-based approach has been pursued to supplement more fundamental policy adjustments; for example, in Chile (see Box 1). 1/

c. Constraints on macroeconomic policies

An open capital account (de facto or de jure) places a particular premium on appropriate macroeconomic policies. The risk of large capital reversals requires that monetary policy is managed so that interest rates and exchange rates are broadly consistent with underlying fundamentals and market conditions. Under fixed exchange rate arrangements, large movements in interest rates may be required to stem outflows in situations where markets question the sustainability of the exchange rate, possibly posing a conflict between domestic and external objectives of policy. Similarly, sharp and costly movements in exchange rates could result if monetary policy is out of line with market expectations where the exchange rate is managed flexibly. Considerable discipline is accordingly also required of fiscal policy so as not to overburden monetary policy.

In recent years several developing countries that have liberalized their capital accounts, many from a position of capital outflows, have experienced sizable net capital inflows. While generally a welcome development, flows that are large relative to the size of the economy can complicate macroeconomic management as well as the task of ensuring that excessive risk-taking does not undermine the health of the financial system. The nature of these macroeconomic and financial sector risks was detailed in the recent International Capital Markets report. 2/ The risks stem from

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1/ The evidence to date is inconclusive in this area. In Chile, which is often quoted as an example of successful supplementary use of controls over short-term inflows, gross capital inflows have remained very strong. The apparent shift in the composition of inflows could be somewhat illusory because of the possible fungibility of different types of flows. There is also the fundamental question of whether the controls on capital inflows are the optimal response. Where fundamental policies are weak, the first-best solution is to correct them; if policies are appropriate, other options, such as sterilization, may be preferable. One lesson from experiences with surges in capital inflows has been the need for better prudential risk management and market information and processing, to lessen the likelihood of market failure. For further discussion of measures taken to control capital inflows in Chile, Colombia, and Malaysia, see Annex III of the background paper.

2/ See "International Capital Markets - Developments, Prospects, and Key Policy Issues" (EBS/95/75, 5/8/95) and Background Material, Part I (SM/95/101, 5/11/95).

Box 1.
Capital Inflows and Reimposition of Controls 1/

In recent years net capital inflows to developing countries have grown substantially, particularly to those countries that have liberalized their capital accounts. Several factors account for this trend, including strong economic performance in recipient countries, successful completion of macroeconomic adjustment and structural reforms in many countries following resolution of debt service difficulties of the early 1980s, and slowdown in economic activity in industrial countries. The structure of these flows has evolved toward direct foreign investment and portfolio inflows. The latter may be viewed as being particularly susceptible to investor sentiments. The following tabulation shows the evolution of key categories of capital flows to developing countries:

(Annual averages in billions of U.S. dollars) 1/

	1977-82	1983-89	1990-94
Total net capital inflows	30.5	8.8	104.9
Net foreign direct investment'	11.2	13.3	39.1
Net portfolio investment	-10.5	6.5	43.6
Other	29.8	-11.0	22.2

Source: "International Capital Markets - Developments and Prospects and Key Policy Issues - Background Material, Part I" (SM/95/101, 5/11/95).

Faced with surges in capital inflows and in the context of other policy adjustments, several countries have chosen to reimpose capital controls in order to slow down inflows. A wide variety of measures have been adopted, including prudential controls on the banking system, market-based measures (special taxes and levies), and quantitative restrictions on inflows and outflows. For instance, in Indonesia, Malaysia, and the Philippines, a tightening of the prudential limits on banks' offshore operations was effected, while Brazil, Chile and Colombia imposed non-interest-bearing reserve requirements against foreign currency borrowing by firms. Malaysia also imposed some quantitative restrictions. Although the prolonged use of such measures would seem distortionary, the experience of these countries suggests that such measures may be justified on prudential grounds and on a temporary basis. On balance, however, capital controls seem to have been far less important in successfully dealing with capital inflows than the adjustment of underlying fundamental macroeconomic policies.

1/ For a discussion of recent experiences see "Recent Experiences with Surges in Capital Inflows," IMF Occasional Paper 108, December 1993; also "Liberalization of the Capital Account - Experiences and Issues," IMF Occasional Paper 103, March 1993.

the difficulties in containing monetary and credit expansion in the context of large inflows, with potentially adverse implications for inflation, the real exchange rate, and the external current account. The threat of sudden reversal further underscores the need for careful adjustment to such inflows. Adjustment in fiscal policy is a key response that may dampen inflows through its effects on interest rates. In most countries, however, it is difficult to use fiscal policy as a short-run response, and it may also exacerbate the problem of unsustainable inflows if confidence grows excessively that the public sector's borrowing requirements will remain manageable.

2. Fund treatment

The Executive Board has thus far not considered comprehensively the specific issue of capital account liberalization with a view to developing guidelines for the membership as a whole. Rather, views on capital account issues have been expressed largely in the context of surveillance, use of Fund resources, and technical assistance activities. 1/ The general approach has recognized the freedom accorded to members under the Articles to maintain or impose capital controls in order to achieve balance of payments and exchange rate stability, providing that "members may exercise such controls as necessary to regulate international capital movements", and even that the "Fund may request a member using its general resources to impose capital controls" (Article VI). 2/ Although it has recognized this freedom, the Fund has tended in the context of its multilateral surveillance discussions and bilateral policy advice to welcome members' actions taken to liberalize capital account transactions, and to urge such liberalization in cases where this was deemed to be a crucial element of broader structural reforms.

1/ The Fund's decision on surveillance over exchange rate policies adopted in 1977 includes among developments that might indicate the need for discussion with a member: "(iii)(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital; ..." *Selected Decisions*, 19th edition (1994), p. 11. As noted earlier, the surveillance decision was amended at the time of the 1995 biennial review of surveillance to take greater account of the importance of private capital flows. The Articles do not, however, give the Fund jurisdiction over exchange controls related to most capital account transactions. Moreover, surveillance has related to the appropriateness of changes--introduction or substantial modification for balance of payments purposes--in a member's capital controls, but it has not lent itself to broad-based appraisals of the outstanding position of a member's system of controls.

2/ Certain transactions which are normally regarded as capital transactions, such as payments of moderate amounts for amortization and normal short-term banking and credit facilities, are deemed by the Fund under Article XXX(d) as being current.

With the movement toward capital account liberalization in industrial countries and in a substantial number of developing countries, the Executive Board has taken a keen interest in the issues arising from the resulting progressive integration of the world's capital markets. In its various multilateral surveillance discussions, the Executive Board has looked upon such integration favorably from the systemic perspective of promoting liberal international trade, sustainable economic growth, and overall economic efficiency. In the World Economic Outlook (WEO) discussion in September 1994, Executive Directors "emphasized that global economic performance will be enhanced by the welcome trend toward currency convertibility and liberalization of capital movements". 1/ This view, however, has not been unqualified, with some Directors expressing concerns regarding the appropriateness of large capital inflows in situations that were not primarily the result of strong policy fundamentals and reform efforts in the recipient countries. As noted earlier, the Board has underscored the importance of appropriate prudential regulatory and supervisory frameworks in guarding against the propensity of financial intermediaries to take on additional risk in an environment of unrestricted capital flows. 2/

a. Policies in Article IV consultations and in the context of use of Fund resources

The Fund has been supportive of the liberalization of capital flows in industrial countries, although the impetus for such liberalization was largely provided by the frameworks of the OECD Code and the EU Directives. 3/ In these cases, the approach has generally been to welcome members' initiatives within the OECD and EU codes and directives and has tended to focus on their systemic implications as well as those for policy fundamentals. 4/ Board views expressed at the time that capital account

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1/ See "Summing Up by the Chairman, World Economic Outlook, Executive Board Meeting 94/82, September 9, 1994" (SUR/94/105, 9/16/94), p. 1.

2/ See "Summing Up by the Chairman, International Capital Markets--Developments, Prospects, and Key Policy Issues" (BUFF/95/44, 5/30/95), pp. 2-3.

3/ For a summary of the main provisions of the codes and directives, see Annex I to the background paper, op. cit.

4/ Greece and Iceland are cases where capital account liberalization was completed only recently and where the Executive Board expressed its views on the issue. For example, in the consultation with Greece, "[Directors] welcomed the recent abolition of the last remaining short-term capital controls; Directors felt that a free financial system, open to the rest of the world, would help Greece return to sustainable growth once the fundamental policy imbalances were decisively addressed". See The Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with Greece, Executive Board Meeting 94/64--July 18, 1994 (SUR/94/84, 7/25/94), p. 2.

liberalization was undertaken suggested a high degree of consensus on its benefits, especially because the liberalization was often accompanied by other market opening reforms.

The Fund has taken a case-by-case approach to capital account liberalization in its consultations with developing countries. While generally eschewing an activist policy of urging rapid liberalization, the institution has in some cases encouraged developing countries to open their economies to foreign capital inflows and to liberalize restrictions on capital account transactions. This approach is particularly demonstrated in countries in central and eastern Europe, where a significant liberalization of foreign direct investment has been one of the objectives of Fund-supported programs. 1/ Within this general setting, the treatment of capital account liberalization in consultations has been selective. The Fund's views have featured prominently in some situations where capital flows have been substantial and called for adjustments in macroeconomic policies. In the recent cases reviewed for this paper involving large capital inflows, a suitable mix of fiscal, monetary, and exchange rate policies was considered as an appropriate response, and the tightening of controls over capital movements as an alternative was generally discouraged. 2/

Although the Fund has generally supported a gradual approach to capital account liberalization, it has encouraged an acceleration of this process in some cases. 3/ A case-by-case approach has also been followed as regards reimposition of capital controls in developing countries in light of their diverse circumstances. The review of specific cases presented in the accompanying background paper is suggestive of a general distaste for

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1/ See the background paper, op. cit., for details.

2/ Cases in which the issue of capital inflows was explicitly addressed in the Chairman's summings up of the discussions of Article IV consultations during 1993-95 were Argentina, Botswana, Chile, Indonesia, Korea, Malaysia, Mexico, Thailand, and Venezuela.

3/ In the 1994 Article IV consultation with Korea, the authorities were encouraged to implement their capital account liberalization program in the hope that "further liberalization of capital outflows could help mitigate the macroeconomic complications associated with strong inflows". In the case of Chile, which also had been gradually dismantling a system of controls on capital movements, the Fund has encouraged further liberalization. Capital account liberalization was also supported in Botswana, where significant private and public capital inflows were accompanied by very large current account surpluses.

such controls as a way of addressing balance of payments difficulties. 1/ In contrast to the general preference for avoiding reintroduction of controls on capital flows, inter alia, for feasibility and credibility reasons, prudential limits on foreign exchange risk exposure have been endorsed. 2/

b. Technical assistance

While the Fund's treatment of the issue of capital account convertibility has been on a case-by-case basis in the context of surveillance and use of Fund resources, an effort to facilitate capital liberalization has been applied more generally through the medium of technical assistance to develop foreign exchange markets. Traditionally, the Fund's technical assistance in the area of foreign exchange systems focused on efforts to facilitate current account convertibility in its member countries; however, from the mid-1980s the focus shifted toward encouraging the adoption of full current and capital account convertibility.

Common themes supporting a move to capital convertibility have included the ineffectiveness of existing controls, improved transparency associated with a free exchange system, the benefits of recognizing an informal market through which a significant proportion of transactions was already taking place, and the need to develop a competitive and efficient exchange

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1/ This view was exemplified by the case of Venezuela where in mid-1994 extensive exchange controls were reimposed in response to the instability created by the domestic banking crisis. In the 1994 Article IV consultation discussion, Executive Directors "regretted the imposition of exchange controls, which...created serious distortions" and "urged the elimination of exchange controls, while recognizing that this could be achieved only in the context of strong fiscal and credit policies and may need to be implemented in a phased manner".

2/ A case in point is Thailand, where the staff suggested that the authorities consider "requiring appropriate provisioning by commercial banks in respect of guarantees against foreign borrowing". See "Thailand--Staff Report for the 1992 Interim Article IV Consultation" (SM/92/90, 3/29/92), p. 6.

system. 1/ The Fund staff has also provided technical assistance in complementary areas, focused in particular on the desirability of maintaining interest and exchange rates at internationally competitive levels. 2/

III. Issues in Extending the Fund's Role in Promoting Capital Account Convertibility

The Fund's role with respect to capital controls was the subject of intense debate in the discussions preceding the Bretton Woods agreements. International responsibilities in this area remained thereafter relatively stable under the par value and related arrangements. However, with the advent of generalized floating in the early 1970s, considerable discussion emerged in the Fund and elsewhere regarding members' obligations under the new international system. This culminated in the issuance of an Executive Board decision on exchange rate surveillance in 1977, which contained specific provisions for the Fund's handling of capital controls. 3/

To date, the Fund's approach has been modest with regard to promoting movement toward a more open system for international capital flows. Considering that all industrial countries and some developing countries have now moved to capital account convertibility and the related globalization of capital markets, a question can be raised whether the Fund should play a significantly more active role in this area than it has done so far. Three approaches are considered below: (i) continuation of current practices; (ii) adaptation of existing surveillance procedures and technical assistance to more actively promote capital account liberalization; and (iii) an extension of the Fund's jurisdiction to capital account transactions. Each of these approaches is discussed below.

1/ Specific arguments have also reflected the circumstances of the individual countries, e.g., decontrol would remove incentives for capital flight and provide incentives for capital reflows; that liberalization is likely to encourage competition in the financial sector and facilitate investment and growth by a more efficient allocation of resources; and that convertibility would facilitate integration into the world economy. For further discussion of particular instances of technical assistance in this area since 1985, see Section III.5 of the background paper.

2/ Assistance has been provided in such areas as linkages with monetary management, prudential mechanisms, monetary policy, general development of instruments and markets, reserves management, reporting systems, legal reform, and the develcpment of interbank market operations in foreign exchange.

3/ See footnote 1 on p. 8.

1. Continuation of current practices

The Fund's broad surveillance mandate under Article IV of the Articles of Agreement calls upon the Fund to take into account the "introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, capital flows" in determining observance by members of principles guiding their exchange rate policies. The 1977 Surveillance Decision further enjoins the Fund to take into account the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal incentives for the inflow or outflow of capital, as well as the influence of long-term capital flows on the behavior of members' exchange rates.

The provisions of the surveillance decision relating to capital controls have been applied to questions of capital account liberalization in some countries. The overall approach has been to support removal of capital controls and to welcome their removal in cases where individual members have liberalized the capital account in a multicountry context such as actual or prospective adherence to the OECD and EU codes, or on their own accord. Article VI gives members a right to maintain capital controls. Reflecting the varied circumstances of its members, Fund programs have generally not included explicit recommendations and performance criteria for capital account convertibility.

In the context of Fund-supported programs in transition economies, active promotion of capital account liberalization was pursued initially with regard to inward foreign direct investment. However, subsequently, and for other categories of capital, the policy recommendations have been more general. Liberalization efforts have been directed primarily toward persuading members to remove restrictions on current international transactions and to accept the obligations of Article VIII, where they have not already done so, without consideration of further actions in the capital account. Technical assistance reports have occasionally gone further, and have included a discussion of the rationale and actual modalities for adopting full convertibility.

2. Adaptation of existing practices to encourage capital account liberalization

An alternative approach would be for the Fund to promote more actively capital account liberalization through its existing surveillance and technical assistance functions, still in the context of the existing Articles. The basis for these efforts would stem from the Fund's mandate under the Articles to exercise surveillance over the exchange rate policies of members. The approach would be motivated by the desire to accelerate the pace of capital account liberalization, recognizing the uneven progress thus far among the Fund's membership. There are two main vehicles through which this approach could be pursued to persuade members to implement appropriate measures: ongoing surveillance activities and technical assistance. In adapting these policies, care should be taken to ensure uniformity.

At the time of the February and April 1995 Executive Board discussions of the biennial surveillance review, the Chairman underscored the importance of capital market developments and the Fund's efforts to strengthen surveillance and adapt to the changing world of increasingly integrated capital markets. 1/ One aspect of such adaptation could be for the Fund to pay greater attention to restrictions imposed by members on capital flows and to encourage their removal in conjunction with appropriate macroeconomic policy adjustments. In the first instance, this would involve strengthening the Fund's information base on regimes governing capital account transactions in individual countries. Information on the effectiveness of the restrictions in limiting capital flows would also be sought. Beyond the identification of restrictions, such an approach would involve more explicit recommendations by the staff regarding the scope for capital account liberalization.

The staff would need to be mindful of a number of complementary considerations. These would include the structure and strength of the balance of payments and external debt; the structure and health of the financial sector, including the effectiveness of prudential and regulatory mechanisms; the appropriateness of the exchange rate; the adequacy of international reserves; and the consistency of interest rate policy with the exchange rate regime. Possible response mechanisms in dealing with destabilizing capital flows would also need to be considered. Such an agenda would represent an expansion of the scope and depth of analysis for most Article IV consultation missions and would need to be supported by concerted technical assistance to a wider group of countries in recognition of the scope for financial sector development in many developing countries.

Further, important issues have arisen concerning the pace and sequencing of capital account liberalization. Considerable judgement would be required about the sustainability of the measures, their sequencing relative to other structural reforms, and the possibility of phased and sequential lifting of specific measures. Analogous to the Fund's strategy regarding acceptance of Article VIII obligations, members would in such cases need to be satisfied that they would not likely require recourse to restrictive measures in the foreseeable future.

Under this approach, the biennial review of members' exchange and payments systems would continue to provide specific discussions of convertibility issues and developments, including an assessment of the systemic implications of the strategy of promoting widespread capital account liberalization. Multilateral surveillance through the WEO exercises and capital market reports would continue to provide the backdrop for members to consider in pursuing capital account liberalization. Strengthening of the database on capital controls in the Fund's *Annual Report on Exchange Arrangements and Exchange Restrictions* would also be undertaken.

1/ "Statement by the Managing Director on Strengthening Fund Surveillance" (BUFF/95/15, 2/15/95).

3. Extension of the Fund's jurisdiction to capital account transactions

A fundamental argument for extending Fund jurisdiction to deal with capital transactions is that the original Articles of Agreement, (including Article VI, Section 3) were framed in a different era, and are no longer in harmony with the new international system of globalized markets and massive capital flows. 1/ Not only has the importance of capital account issues increased, but recent experience has indicated the difficulty in making exchange controls effective. There would be credibility gains regarding the authorities' commitment to a liberal system for trade and financing arising from their acceptance of capital convertibility. For these reasons, the provisions of Article VI, Section 3, and to the extent necessary related provisions in other Articles, could be reconsidered. 2/

The need for the Fund to reconsider its approach to capital account restrictions also arises from the role of capital liberalization in broader aspects of financial market development. There would be clear systemic benefits from capital account liberalization on a broadly multilateral basis. One result that has become clear is that the development of more sophisticated financial instruments (for example, forex forwards or futures) is dependent upon freedom from direct controls or incentives on a very broad basis. Capital convertibility has thus become even more bound up with other aspects of the Fund's role in promoting development of financial institutions and infrastructure.

1/ The framing of the original Articles took place in the context of a debate of the role of speculative versus productive capital movements. In the international environment of the Bretton Woods arrangements, difficulties arising from such distinctions were seen to be less crucial simply because of the limited volume of capital transactions. However, with the integration of the global economy and the enormous growth in capital transactions, these difficulties have moved to center stage.

2/ There is no evidence in the legislative history of the Fund that the concept of "necessary" in Article VI, Section 3 was intended to limit the authorities' discretion in any way, and this argument has never been invoked in the practice of the Fund. Indeed, when this provision was explained to the U.S. Congress prior to ratification, it was stated that, under this provision, member countries have the right to control capital exports when such control is regarded by them as desirable. The primacy of the right under Article VI, Section 3 was confirmed in 1956, when the Committee on Interpretation of the Executive Board concluded that the use of discriminatory currency arrangements for control of capital movements did not require Fund approval under Article VIII, Section 3. It is also worthy of note that, at the time of the Second Amendment, no modification was made to Article VI, notwithstanding the changes that had taken place in the international exchange rate arrangements.

The scope of Article VI, Section 3 has affected the Fund's consideration of capital controls, as evident in the absence of a broad-ranging Executive Board discussion of this issue since the 1970s, and also in less focus on data and experiences than has been accorded to restrictions on the current account of the balance of payments. One benefit of extending jurisdiction would be to harmonize better across the entire Fund membership the treatment of exchange controls for capital with the consideration accorded to restrictions on current account transactions, including the transitional arrangements under the Articles for such restrictions. 1/

Evidence that controls on short-term capital inflows can be effective in providing temporary breathing space for the strengthening of macro-economic policies suggests that some special provision might well be desirable for such flows. On the other hand, the increasing fungibility of short- and long-term capital by maturity, particularly in times of balance of payments crises, can be seen as making such a distinction difficult to apply in practice. Just as leads and lags on trade financing offer an escape valve, so too do movements of longer-term capital, owing to the delay or acceleration of investment decisions and the role of secondary markets in which residents participate. Accordingly, the approach of the OECD and EU codes, as amended in the late 1980s to comprehend short-term capital symmetrically, would seem a desirable one for the Fund to follow in itself, as well as for reasons of international consistency. Bringing direct investment under the ambit of an enhanced Fund code, particularly the exchange aspects, would also have the benefit of introducing considerable symmetry with the OECD and EU codes. 2/

1/ Increasingly in recent years, Article VIII obligations have been adopted in tandem with capital convertibility, raising an issue of whether obligations under the original Article VIII should be merged under an expanded Article VIII that included capital account transactions. Such an approach would remove ambiguous administrative separations between the current and capital transactions that has on occasion impeded elimination of controls on current account transactions. (Even within the Fund numerous legal questions have arisen in connection with Article XXX.) Extending the Fund's jurisdictional interest to capital transactions, could therefore ease completion of the unfinished business represented by the 76 countries that remain under the transitional arrangements of the Fund's Article XIV. It would also allow for a flexible treatment of the question of reimposing capital controls, as there are already under arrangements for Article VIII approval policies to provide for members' rights to effect such reintro-ductions in the case of current account transactions, subject to certain criteria that have been applied in a pragmatic fashion.

2/ Another issue of transactions coverage results from the fact that Article VIII refers to payments and transfers for, and not receipts accruing from, current international transactions. Repatriation and surrender requirements are in many ways similar to capital controls, and are important in determining the efficiency of foreign exchange markets.

If extension of the Fund's jurisdiction was thought preferable, a learning period of, say, 2-3 years might be desirable--as well as needed--for the Fund to build up its information and policy approaches in this area and assess resource implications, before consideration of whether to pursue a formal jurisdictional extension. One aspect of this interim period could be the distribution of questionnaires to members seeking full information, along the lines of the OECD codes. In this way, the Executive Board could leave open the option of extension of jurisdiction, while at the same time gaining valuable experience and knowledge on capital account issues.

4. Relations with other organizations

Any approach to fostering capital account liberalization would be facilitated by appropriate coordination with other multilateral institutions. Considerable expertise in this area now exists at the OECD and the EU, and their codes and directives as regards liberalization of capital movements could initially serve as a useful guide. The Fund would need to develop similar mechanisms, albeit for a much wider range of countries, which could be facilitated by intensifying an ongoing dialogue with these institutions on capital account matters. Apart from building an information base, such a dialogue would also be necessary to ensure that actions taken by members in response to destabilizing capital movements do not discriminate against other Fund members. 1/ If the Fund's jurisdiction were to be extended to the capital account, the implications of any jurisdictional overlap between the Fund and other entities would also need to be clarified. Relations with the OECD will be an important consideration, particularly in view of the May 23-24, 1995 agreement by OECD members on the immediate start of negotiations aimed at reaching a multilateral agreement on investment by 1997. 2/ The agreement would aim at providing a multilateral framework, open also to non-OECD member countries, for the liberalization of investment regimes and investment protection. In addition, in light of the advance made in the General Agreements on Trade in Services on the liberalization of certain capital movements, it would be important to collaborate with the World Trade Organization. 3/

5. Financing considerations

A more active role on the part of the Fund in seeking capital account liberalization would raise the issue of providing financing to members faced with balance of payments pressures emanating from the capital account. One concern might be that the Fund could become increasingly involved in financing fluctuations of capital flows, since by accepting the obligations of an

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1/ For instance, the EU directive calls for consultation among its members and a collective response to disruptive capital movements relating to third countries.

2/ "Communiqué of the OECD" (EBD/93/73, 5/26/95).

3/ "The Relationship of the World Trade Organization with the Fund-Legal Aspects" (SM/94/303, 12/20/94).

expanded Article VIII members may expect that they would be supported by access to Fund financing in the event that they experience pressures due to capital account imbalances. Specifically, consideration would have to be given to the revision of Article VI, Section 1, which specifies that Fund resources could not be used to "meet a large or sustained outflow of capital".

Issues also arise regarding the size of the financing that would be needed, the speed with which it would need to be provided, and its relationship with other forms of private and official financing. 1/ In this context, the increase in annual access limits and the possibility of greater access under exceptional circumstances provides the Fund with greater scope in addressing members' financial needs. The Halifax Summit communiqué urged the Fund to establish an emergency financing mechanism to provide faster access to Fund arrangements with strong conditionality and larger up-front disbursements in crisis situations. 2/ Another issue is whether financing would be needed in support of members' liberalization of the capital account, analogous to the balance of payments need associated with structural reforms under EFF and ESAF programs. Preferably, appropriate policy adjustments would be advocated to address any adverse effects on the balance of payments, but cases could be envisioned where an appropriate combination of adjustment and financing might be desirable.

IV. Issues for Discussion

Directors may wish to discuss the following issues:

- Has the Fund paid sufficient attention to encouraging liberalization of still widespread controls on capital outflows?

- What are Directors' views on the experience of the countries that they represent and of the membership in general with respect to maintaining or reintroducing controls on capital inflows and outflows? If the view is accepted that capital account liberalization, when introduced, should not be reversible, do Directors see implications for the way that liberalization should be approached by the Fund?

- What are Directors' views on the efficacy of specific efforts to deter or slow capital inflows by quantitative controls or incentives, for countries experiencing a surge in such inflows, as a supplement to the traditional tools of macroeconomic policy? Are there risks that such steps may be used as a reason to delay policy adaptations? Can such measures be effective as a way to buy time for policy makers to assess and react to an unfolding situation?

1/ For a more detailed discussion of these issues see "Short-Term Financing Facility" (EBS/94/193, 9/26/94).
2/ "Communiqué of the Group of Seven" (EBD/95/84, 6/16/95).

- Has the present treatment by the Fund of capital account policies under its surveillance and technical assistance arrangements provided sufficient focus and emphasis on capital account liberalization? Has the existence of Article VI inhibited the Fund's central role in the area of exchange rates and payments systems?

- Would it be desirable to extend the Fund's jurisdiction to cover capital account restrictions by an amendment to the Fund's Articles at some stage, or can an increased focus on capital liberalization be accommodated within an adaptation of surveillance and technical assistance practices? What is the relevant role of the Fund vis-à-vis other multilateral and regional institutions for considering these policies within an integrated macroeconomic and multilateral perspective?

- What would be the desirable modalities, and how could the staff prepare for, an extension of Fund activities in this area? What would be the merits and demerits of accepting the present treatment under the OECD and EU codes for developing countries? If Fund jurisdiction were to be extended, would there be benefit in operating on a trial basis in order to accumulate experience, both with the modalities for a possible eventual amendment to the Fund's Articles, and for more immediate purposes?